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"New Horizon"

POST OFFICE BOARD: 20 July 1999 **POB(99)47**

IMPLICATION ON THE POST OFFICE OF THE 24 MAY 1999 HORIZON AGREEMENT

Purpose:
The Board must decide by 31 July 1999 if it can and wishes to terminate or sign the revised contract with ICL for the automation of post offices. The signing of the contract will commit Post Office Counters Ltd to significant financial undertakings. In addition, the Government has informed The Post Office that it intends to move all benefit recipients with bank accounts to ACT from 2003 to 2005. This paper outlines the impact and seeks Board approval to the signing of the contract with ICL.

Strategic implications:
The implications are:
- significant additional costs of the Horizon infrastructure;
- a fall in benefit payments business following the promotion of, or compulsion to, ACT;
- potential force majeure closures of between 2,000 and 7,000 offices impacting both POCL's nationwide network and RM and PFWW's universal service obligations;
- that continuation (with ACT) supports Network Bank aspirations;
- the lack of a benefit card, together with ACT, damages Government Gateway strategy, making it only marginally positive over 10 years;
- loss of footfall, reduction in office numbers and an increase in costs due to Horizon have a significant adverse impact on Royal Mail and PFWW.

Costs/benefits:

		Impact on POCL NPV (£m)		Impact on PO NPV (£m)	
Scenario	No.	5 Year	10 Year	5 Year	10 Year
Continue	1	-189	-161	-134	-115
Continue	2	-278	-487	-319	-672
Continue	3	-443	-674	-484	-859
Terminate	4	-1011	-1310	-1098	-1540
Terminate	5	-654	-1002	-777	-1336

Continuing with Horizon is least bad.

Recommendations:
The Board is asked to agree to:

then usual MaPEC procedure

- the signing of the revised contract with ICL;
- interim project funding of £11.03m until a formal MaPEC in September; and

to agree that work should continue on:
- stopping or delaying the move to ACT;
- reducing the ongoing cost of Horizon;
- reviewing channel strategy;
- persuading Government to ring fence the Horizon costs; and
- how the Government could subsidise the nation-wide network.

ME pick up on POB minute for Sept MaPEC

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did PO agree?

emailed

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POST OFFICE BOARD
IMPLICATION ON THE POST OFFICE OF THE 24 MAY 1999 HORIZON AGREEMENT

1. Background
Heads of Agreement with ICL on the future of Horizon were signed on 24 May 1999. Detailed codification of these Heads into a contract are expected to have been completed by 16 July 1999 prior to the Board's consideration of its terms on 20 July 1999. The signing of the contract will commit Post Office Counters Ltd to significant financial undertakings. In addition the Government has informed The Post Office that it intends to move all benefit recipients with bank accounts to ACT between 2003 to 2005.

2. Purpose of the paper
This paper outlines the impact of the new contract and seeks Board approval to the signing of the contract with ICL.

3. Context
The original contract with ICL was signed in May 1996. The Horizon business case was approved on the basis of protecting benefit payment income by the automation of the network and the introduction of the benefit payment card. The contracts between POCL and BA, and POCL and ICL were back to back. Recognising that benefit business was expected to decline after the end of the contract with the Benefits Agency in 2005, POCL developed a new vision. As part of the vision it was envisaged that the counter network would be automated and that future business could be built on the benefit payment card. The commercial strategies identified, particularly Network Bank and Government Gateway, depended on an automated platform and the development of a smartcard.

Following extensive reviews by Government, BA withdrew from the Horizon project on 24 May 1999, ending its need for a benefit payment card. The Board agreed that POCL would continue with the project on new commercial terms subject to the agreed codification of the Heads of Agreement signed on 24 May 1999 (with an option that if codification was not agreed, POCL could terminate with the payment of £150m to ICL), and the use of £480m of gilts to fund payments to ICL. The codification process ended on 16 July 1999 without any material disagreement allowing termination.

The key elements of the new deal are:
- functionality consists of Electronic Point of Sale (EPOS), automated payments, local feeder systems and the Order Book Control System (OBCS: bar-coded order books);
- additional functionality, such as Network Banking and Government Gateway, will be possible at an extra cost of c£120m;
- the system will be rolled out by March 2001 (based on a roll out rate of 300 offices a week);
- the contract will terminate on 31 March 2005;
- payments will be made as follows:

- Capital sum of £480m to be paid, less a 25% retention, over the next two years (retention to be paid over subsequent four years);
- a payment of £68m to be made on acceptance;
- following roll-out, operating payments to be made of c£95m p.a.;
- operating costs are 61% fixed, 32% variable with number of outlets and 7% variable with volume;
- in addition POCL will have to bear the cost of unrecovered VAT;
- termination options available are:
  - system fails acceptance, and no payments to ICL;
  - for convenience, with payments in the order of £450m.

Currently there is no new deal with BA to cover the existing manual benefit payment and the new OBCS. BA is holding firm to a negotiating position agreed with its Secretary of State, which is worse for POCL than the modelling done for Treasury at the time of the decision. Currently, POCL and BA are some £265m NPV apart (the attached financials take a mid point position). Discussions have been held with the McCartney Working Party on how to un-block BA's negotiating position. This would enable POCL to reach a satisfactory commercial arrangement based on BA contributing to the cost of automation in line with its share of business volumes.

4. Evaluation of impacts

In evaluating the new contract, the following scenarios were examined:

1. Horizon continues with increasing drift to ACT.
2. Horizon continues with heavy promotion of ACT.
3. Horizon continues with compulsory ACT from 2003 to 2005.
4. Horizon is terminated and an alternative automation is introduced, with compulsory ACT.
5. Horizon is terminated and no alternative automation is introduced, with compulsory ACT.

All scenarios have a negative NPV. The least bad scenario, Horizon and ACT drift, has significant negative cash flows and losses over the next four years. In all other scenarios the cash flows are negative and POCL incurs losses for the next ten years.

The consequential impacts on Royal Mail and Parcelforce Worldwide, and the loss of interest on the £480m of investment, further worsens the Group position. Some benefit may be available from tax relief from capital allowances.

A summary of the cash flow and profit and loss position is at Annex A. In NPV terms the relative positions are as follows:

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Scenario	Impact on POCL £m				Impact on PO £m			
	5 Year		10 Year		5 Year		10 Year	
	NPV	Ave. profit	NPV	ave. profit (2nd 5 years)	NPV	Ave. profit	NPV	ave. profit (2nd 5 years)
Bus. Plan	43	54	226	166	n/a	n/a	n/a	n/a
1	-189	-82	-161	65	-134	-72	-115	60
2	-278	-108	-487	-47	-319	-122	-672	-117
3	-443	-150	-674	-58	-484	-164	-859	-128
4	-1011	-166	-1310	-91	-1098	-187	-1540	-161
5	-654	-94	-1001	-149	-777	-124	-1336	-257

The differences between the impact on POCL and PO are the impacts on Royal Mail, PFWW and Group (interest and tax).

Therefore, in terms of relative positions, continuing Horizon is least bad.

5. Strategic responses
The evaluation has already taken account of a number of commercial responses (NPV calculations based on Scenario 2):

- Network Bank, and the signing up of four of the top five banks by 2003, which is based on value share and not commodity pricing. Work to date indicates that Network Bank will contribute some £260m NPV over 10 years (with a terminal value of £420m). Although banks are interested, no bank has yet signed up on this basis;
- Government Gateway, based on value share, contributing only £8m NPV over 10 years (but with a terminal value of £192m). Support through the McCartney Working Group will be needed if this position is to be improved upon;
- cash and distribution work for the banks contributing £90m NPV (with a terminal value of £45m);
- network closures contributing some £26m NPV over 10 years (with a terminal value of £130m) depending on the level of compensation.

All these areas require investment over and above direct Horizon programme costs (but included in the financial analysis), and are not without risk.

In terms of Royal Mail and PFWW, an investment decision in favour of Horizon has significant adverse consequences:

- lost revenue from reduced footfall and office closures, and the cost of alternative channels, is estimated to be as high as £58m and £20m p.a. respectively;
- in addition, under the inter-business contract, both RM and PFWW will pick up a share of the costs of automation (£30m p.a. and £3m p.a. respectively in steady state).

At these levels of cost, the network compares unfavourably with the experiences gained from mail order and retail stamp sales. Royal Mail considers there to be no viable options to recover or absorb these costs. There could be a case to be made to a regulator that the additional costs are part of the cost of the Universal Service Obligation (USO). If successful, and to cover the costs to Royal Mail, a price increase of 2p/2p on the postage stamp stream

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would be necessary (i.e. excluding the "commercial" meters and pre-paid streams). The price increase would have to be in excess of 4p/4p to cover the entire loss in POCL. Any increase in the price would worsen Royal Mail and PFWW's competitiveness. A price increase and "subsidy" to POCL would be likely to have political consequences and would raise significant competition issues.

The key elements to improving the financial impacts are:
- slowing the move to ACT;
- reduce the ongoing cost of Horizon (see Board paper POB(99)48 on Accounting, Funding and Tax);
- reduce channel costs (through new channels and reducing network);
- ring fence the Horizon costs from other Post Office business; and
- Government commitment and subsidy of the nation-wide network.

5. Financial re-authority
Following the Board's decision a business case will be produced and submitted to MaPEC for formal authority for project expenditure. However, the project will reach its Maximum Authorised Expenditure (December 1996) by the end of July. The project requires additional project funds to cover the period to the end of September 1999. The project requires, therefore, approval of payments to ICL and interim funding of £11.03m until formal MaPEC approval.

6. Recommendations
The Board is invited to <u>note</u>:
(i) the impacts of continuing or terminating Horizon;
(ii) that continuing, while bad, is better than termination.

on what exactly

The Board is asked to <u>agree</u> to:
(iii) the signing of the revised contract with ICL following a codification of the 24 May 1999 Heads of Agreement, and the associated payments to ICL;
(iv) interim project funding of £11.03m until a formal MaPEC in September.

The Board is asked to <u>agree</u> that work should continue on:
(v) stopping or delaying the move to ACT;
(vi) reducing the ongoing cost of Horizon;
(vii) reviewing channel strategy, including its cost, alternatives and its impact on the universal service obligations of The Post Office;
(viii) persuading Government to ring fence the Horizon costs from other Post Office business; and
(ix) how the Government could subsidise the nation-wide network.

Stuart Sweetman
July 1999